# Impact of CEO and Executive Compensation on Performance of Takaful: Evidence from Pakistan

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**_Abstract_**

*The purpose of this article is to investigate whether compensation (i.e. salary, bonus and allowances) offered to chief executive officers and executives affect the performance of Takaful (i.e. Islamic insurance) companies in Pakistan. Data was collected from annual reports of Takaful companies during 2007-2015 to estimate the relationship between compensation and accounting-based performance measures such as return on assets (ROA), return on equity (ROE) and earnings per share (EPS). It is worth mentioning that Takaful companies are unquoted on Pakistan Stock Exchange that is why only accounting-based performance measures used in this paper. Results indicate that compensation offered to CEOs and executives is statistically significant and negatively related to all performance measures. Descriptive statistics indicate that mean ROA and ROE are negative while mean EPS is positive but it is too small to dispense among shareholders. Although Takaful companies are offering reasonable compensation to CEOs and executives but their performance is weak which may be due to absence of monitoring from the market participants. In sum, offering reasonable compensation to CEOs and executives despite poor performance indicates the prevalence of weak governance structures that leads to agency problems.*

**Keywords:** Agency theory, CEO compensation, Directors' compensation, Pakistan

## 1. Introduction:

Takaful is an Arabic word that means guaranteeing each other or joint guarantee or shared responsibility. Takaful is a *Shariah* compliance mutual risk transfer arrangements which involves participants and operators. This is a mutual sharing of risk based on the concept of *Taawun* i.e. mutual protection. Whether the compensation offered to CEOs and executives affect the firm performance? This question has been widely studied in the corporate governance literature but unluckily findings are equivocal. According to agency theory, a firm may align the interests of managers with shareholders by offering reasonable compensation. Several researchers have explored the effect of compensation offered to CEOs and executives on performance using data of non-financial firms. In contrast, less attention paid on financial firms due to the reason that these firms performed functions in a regulated environment.

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In particular, a little is known about financial firms that deals in products based on the principles of *Shariah* such as Islamic banks and Islamic insurance (i.e. Takaful) etc. A number of empirical studies have explored the impact of internal characteristics of Islamic banks on performance whereas no attention paid on Islamic insurance. To the authors' knowledge there is no study that has explored the impact of CEO and executive compensation on performance of Takaful companies in Pakistan. We expect that outcome of this paper attempt to fill a gap that exists in the literature with reference to Islamic insurance in Pakistan. Moreover, it provides support to top management, prospective investors and regulatory authorities to understand the relationship between compensation and performance.

The rest of the paper proceeds as follows. Section 2 describes the findings of earlier empirical studies on the relationship between compensation and corporate performance. Section 3 describes data and methodology. Results and discussion on empirical findings presented in Section 4. Section 5 presents the conclusion of the study.

## 2. Literature Review:

This section briefly demonstrates the findings of earlier empirical studies on the relationship between compensation (offered to CEOs and executives) and financial performance. For instance, John Core et al.[1] conducted a study to examine the impact of governance variables along with CEO compensation on firm performance. They observed that board structure and ownership structure significantly affect the CEO compensation. Moreover, they observed that CEOs at firms with weaker governance structures receives greater compensation but severity of agency problems in these firms makes the performance worse. Michael Firth et al.[2] analyzed the data of Chinese listed companies to examine the effect of CEOs compensation on corporate performance. They observed that under certain types of ownership, compensation varies with performance. For example, when state/government is the largest shareholder then CEO compensation does not depend on firm performance however when the controlling shareholder is state owned enterprise (SOE) or a private blockholder then CEO compensation is positively related to accounting-based (i.e. return on sales) and market-based (i.e. stock returns) measures of performance. Roman Matousek and Nickolaos Tzeremes[3] analyzed the data of 37 banks in United States during 2003-2007 to investigate the effect of CEO compensation (i.e. bonus and salary payments) on banks' technical efficiency levels. They found a non-linear relationship between compensation and banks' efficiency levels. Moreover, they observed that higher bonus and salary payments not always associated with higher technical efficiency levels. Sudhir Jaiswall and Asish Bhattacharyya[4] used the data of Indian firms during 2002-2013 to explore the association between CEO compensation and board, ownership, and CEO characteristics. They found that compensation attributed to CEO and ownership characteristics is positively while compensation attributed to CEO and board characteristics are not. They found their results congruent with efficient CEO compensation contracting rather than CEO rent extraction theorem. Florens Focke et al.[5] conducted a study to explore the relationship between prestige/pride of a publicly listed firm and CEO's compensation. They observed that CEOs are ready to receive

lower compensation if they are working for a prestigious firm. Their results indicate that CEOs of top 100 *Fortune* firms' compensation grow 8% less than CEOs of firms outside this ranking. They suggest that CEOs can happily accept lower compensation because of improvement in their social status as well as to gain future career benefits for being part of a company that enjoys public admiration. Basil Al-Najjar[6] analyzed the data of travel and leisure firms listed in UK to investigate the impact of board and CEO characteristics on CEO compensation. He observed that board independence, age of the CEO and board size are some important variables that affect the CEO remuneration. Moreover, their results indicate a positive non-linear relationship between CEO tenure and performance. Keryn Charlmers et al.[7] analyzed the data of top 200 firms listed on Australian Stock Exchange during 1999-2002 to investigate the impact of economic, governance and ownership variables on CEO compensation. They observed that economic attributes have material effects on CEO compensation in Australia. Moreover, governance and ownership attributes also have a role in determining the CEO compensation. Governance and ownership attributes have differential influence on different CEO compensation components. Huasheng Gao and Kai Li[8] analyzed the data of US publicly held and privately held firms during 1999-2011 to compare and contrast the compensation offered to CEOs and its impact on performance. They observed that CEOs in publicly listed firms earn thirty percent more compensation than CEOs in privately held firms. Moreover, they observed that CEO compensation is positively link to accounting-based performance. Mehul Raithatha and Surenderrao Komera[9] used the data of all listed firms (except financial firms) in India during 2002-2012 to investigate the relationship between executive compensation and performance. They observed that compensation offered to executives significantly affect the performance determined using accounting-based measures. More importantly, the relationship between pay and performance is much obvious in large firms than in small firms. Finally, they found an insignificant relationship between pay and performance in business group affiliated firms.

**3. Data and Methodology:**

We took data from annual reports (i.e. income statement, balance sheet and cash flow statement) published by Takaful companies during 2007-2015 to estimate the relationship between compensation and performance. The reason for being taking data from 2007 is that Takaful companies have started operations in Pakistan during 2005-2010. Currently five Takaful companies are operational in Pakistan namely Dawood Family Takaful Limited, Pak Qatar Family Takaful Limited, Pak Qatar General Takaful, Pak Kuwait Takaful and Takaful Pakistan Limited. Notably, Takaful companies have obtained the certificate of registration from Securities and Exchange Commission of Pakistan (SECP) but they are unquoted on Pakistan Stock Exchange. Owing to this reason, only accounting-based performance measures such as ROA, ROE and EPS used in this paper. Other variables and their definitions are reported in Table 1. All Takaful firms were included in study however incomplete observations were deleted thus final sample consist of 39 firm-year observations during 9 years. Pooled ordinary least squares method used to estimate the relationship between compensation and performance of Takaful companies.

**Table 1:** Definition of variables

| **Variable** | **Symbol** | **Definition** |
|---|---|---|
| Return on assets | ROA | Profit before taxes / Total assets |
| Return on equity | ROE | Profit before taxes / Stockholders equity |
| Earnings per share | EPS | As reported in annual reports. |
| CEO compensation | CEOC | Natural log of CEO compensation. CEO compensation consist of salary + bonus + allowances for house, medical, conveyance and utilities etc. |
| Executives' compensation | EXEC | Natural log of executive directors' compensation. Compensation consist of salary + bonus + allowances for house, medical, conveyance and utilities etc. |
| Leverage | LEV | Total liabilities / Total assets |
| Size | SIZE | Natural log of total assets |
| Total asset turnover | TATO | Total investment and other income / Total assets |

**4. Results and Discussion:**

Descriptive statistics presented in Table 2 indicate that maximum value of return on assets (ROA) is 10.60 percent while mean value is negative. Similarly, mean return on equity (ROE) is negative while maximum value is 22.42 percent. Although mean value of earnings per share (EPS) is positive but it is too small to dispense among the stockholders. Mean natural log of CEO compensation and executive compensation is 15.34 and 17.01 respectively. The mean leverage is 54.10 percent. The mean natural log of total assets is 20.59 while mean of total assets turnover is 0.033 times which is too low to show the efficient utilization of assets.

**Table 2:** Summary statistics

| **Variable** | **N** | **Mean** | **SD** | **MIN** | **MAX** |
|---|---|---|---|---|---|
| ROA | 39 | -0.0153 | 0.0691 | -0.2083 | 0.1060 |
| ROE | 39 | -0.0138 | 0.1369 | -0.3068 | 0.2242 |
| EPS | 39 | 0.0120 | 0.7660 | -1.3600 | 1.4700 |
| CEOC | 39 | 15.344 | 1.0057 | 12.484 | 16.490 |
| EXEC | 39 | 17.018 | 0.9032 | 15.248 | 18.855 |
| LEV | 39 | 0.5410 | 0.2872 | 0.0204 | 0.9506 |
| SIZE | 39 | 20.599 | 0.8587 | 19.531 | 23.216 |
| TATO | 39 | 0.0333 | 0.0242 | 0.0033 | 0.1104 |

Results reported in Table 3 indicate that CEO compensation is significant and negatively related to all performance measures i.e. ROA, ROE and EPS. As control variables concerned, leverage is significant and positively related to all performance measures. Firm size positively linked to ROE and negatively related to

ROA and EPS but the relationship found significant with ROA only. Total assets turnover is significant and positively linked to ROA and EPS.

Results presented in Table 4 indicate that compensation offered to executive directors of Takaful is significant and negatively related to all performance measures. As other variables concerned, Firm size and leverage significantly positively linked to all performance measures. Total assets turnover positively linked to all performance measures however the relationship found significant with ROA and EPS.

Descriptive statistics presented in Table 2 indicates that mean ROA and ROE are negative. In contrast, average EPS is positive but it is too small to dispense among shareholders. It is worth mentioning that Takaful companies are unquoted on Pakistan Stock Exchange and avoid monitoring of market participants. Moreover, Table 2 indicates that the average value of compensation offered to CEOs and executive directors is quite reasonable. Thus, absence of strong monitoring from market participants is an important reason for negative association between compensation and performance. More importantly, distribution of reasonable amounts of remuneration to CEOs and executives despite poor performance indicates the prevalence of weak governance structures that leads to agency problems. Resultantly, severity of agency problem makes the performance worse.

**Table 3:** Effects of CEO compensation on financial performance

| Dependent Variables | *ROA* | | *ROE* | | *EPS* | |
|---|---|---|---|---|---|---|
| Independent Variables | Coefficient | *t*-statistic | Coefficient | *t*-statistic | Coefficient | *t*-statistic |
| *C* | 0.4867 | 1.53 | -0.685 | 0.10 | 2.819 | 0.78 |
| *CEOC* | -0.023** | -2.40 | -0.048** | -2.39 | -0.236** | -2.15 |
| *LEV* | 0.173*** | 3.95 | 0.208** | 2.26 | 1.737*** | 3.48 |
| *SIZE* | -0.012*** | -0.89 | 0.025 | 0.82 | -0.020 | -0.13 |
| *TATO* | 0.7903* | 1.68 | 1.052 | 1.07 | 9.544* | 1.79 |
| *R-Sq* | 0.3656 | | 0.2878 | | 0.3357 | |
| *Adj R-Sq* | 0.2910 | | 0.2040 | | 0.2576 | |
| *Root MSE* | 0.0582 | | 0.1221 | | 0.6600 | |
| *f-Statistic* | 4.90 | | 3.43 | | 4.30 | |
| *Prob.* | 0.0031 | | 0.018 | | 0.0064 | |
| *N* | 39 | | 39 | | 39 | |

**Table 4:** Effects of executives' compensation on financial performance

| Dependent Variables | *ROA* | | *ROE* | | *EPS* | |
|---|---|---|---|---|---|---|
| Independent Variables | Coefficient | *t*-statistic | Coefficient | *t*-statistic | Coefficient | *t*-statistic |
| *C* | 0.238 | 0.86 | -0.467 | -0.77 | 0.223 | 0.07 |
| *EXEC* | -0.071*** | -3.22 | -0.126** | -2.58 | -0.629** | -2.38 |

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|---|---|---|---|---|---|---|
| *LEV* | 0.123*** | 4.90 | 0.303*** | 2.93 | 2.213*** | 3.97 |
| *SIZE* | 0.039* | 1.81 | 0.116** | 2.43 | 0.434* | 1.69 |
| *TATO* | 0.985** | 2.08 | 1.230 | 1.25 | 10.487** | 1.97 |
| *R-Sq* | 0.4315 | | 0.3040 | | 0.3532 | |
| *Adj R-Sq* | 0.3646 | | 0.2221 | | 0.2771 | |
| *Root MSE* | 0.0551 | | 0.1207 | | 0.6513 | |
| *f-Statistic* | 6.45 | | 3.71 | | 4.64 | |
| *Prob.* | 0.0006 | | 0.0130 | | 0.0043 | |
| *N* | 39 | | 39 | | 39 | |

## 5. Conclusion:

The aim of this article is to investigate the impact of CEO and executive compensation on financial performance of Takaful companies in Pakistan during 2007-2015. Results indicate that compensation offered to CEOs and executives is significant and negatively related to financial performance measured as ROA, ROE and EPS. Notably, Takaful companies are unquoted on Pakistan Stock Exchange that is why only accounting-based performance measures used in this paper. Descriptive statistics indicate that mean ROA and ROE are negative while mean EPS is positive but it is too small to distribute among the shareholders. Although Takaful companies are offering reasonable remuneration to CEOs and executives but their performance is weak which may be due to absence of monitoring from the market participants. Thus, offering reasonable compensation to CEOs and executives despite poor performance indicates the existence of weak governance structures that leads to agency problems. Findings of earlier empirical studies confirm that agency problem between managers and shareholders make the performance worse. We are sure that findings of this study provide support to top management in determining a balanced compensation package for CEOs and executives in relation to firm performance. Finally, we recommend that there is a dire need to enrich the literature by empirically exploring the impact of governance variables (e.g., board size, board independence, CEO duality, and ownership structure etc.) on financial performance of Takaful companies in Pakistan.

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